



Multistate Tax Commission Memorandum

States Working Together Since 1967 . . . To Preserve Federalism and Tax Fairness

To: Members of the Executive Committee
From: Dan Bucks, Executive Director
Date: July 9, 2004
Subject: Staff Recommendations on Implementation of the State Tax Compliance Initiative Recommendations

The State Tax Compliance Initiative has proposed a series of significant, substantive recommendations to improve state tax compliance. The memorandum of July 9, 2004, to you from Elizabeth Harchenko, Compliance Initiative Steering Committee Chair, summarizes those recommendations. This memorandum supplements the Chair's summary by providing comments and recommendations for the Executive Committee's consideration on how to implement those recommendations.

In general, the implementation steps involve three different ways to proceed:

1. **Standing Committee Responsibility.** In this case, the Executive Committee would refer a recommendation to a Standing Committee for implementing the measure. Where several measures might be referred to a committee (e.g. Uniformity), the Executive Committee may indicate a priority among the recommendation. A variation includes a few instances where the Standing Committee would be assisted by a special work group involving states or persons not currently members of the Standing Committee.
2. **Special Task Force.** In this case, the Executive Committee would create a special task force—with the membership or at least the support of top tax administrators of participating states—that would undertake the implementation of the recommendation and would report to the Executive Committee. Often this involves recommendations that cut across the boundaries of existing committees, although those committees may be called upon to help support the task force and otherwise coordinate with it. Membership on the special task forces would be open to all states—and coordination with the FTA would be sought.
3. **Executive Committee Responsibility.** In this case, the Executive Committee would, at least at the outset, retain direct responsibility for supervising the implementation of the recommendation. It may, at a future date, delegate part or all of the implementation of the recommendation to a task force or standing committee.

While principal responsibility might be assigned to a Standing Committee, Special Task Force, or to the Executive Committee itself, efforts would need to be undertaken to ensure communication among all affected parties on these matters.

With these general modes of implementation in mind, the staff provides the following comments on how each recommendation might be implemented. Please note that with respect to the pass-through entity and corporate tax sheltering recommendations that have not yet been approved by the Executive Committee, these staff recommendations should be interpreted in the context of “if the Executive Committee approves the recommendation, here is a way to proceed.” This memorandum takes the summary from the Steering Committee Chair’s memo, including the bold-faced language set off by “**”, that comprise the Compliance Initiative’s comments on implementation, and adds the staff comments in blue type. Please note, also, the table at the end of this memorandum the brief table that summarizes the initial assignments recommended here.

Corporate Income Tax Sheltering Recommendations

The following are the recommendations from the Corporate Tax Sheltering Work Group Report, pages 68-69:

1. **Combined Reporting.** States should adopt combined reporting for jointly owned and operated companies. Dividends from affiliates that are not members of the combined group should be treated as apportionable income unless the holding of stock or receipt of the income is clearly unrelated to the business of the owner. **** This reinforces the MTC Federalism at Risk recommendation on combined reporting and the MTC Uniformity Committee’s current project to develop proposed uniform combined reporting statutes and regulations. ****

Staff recommendation: The Uniformity Committee is working on this project. *Recommendation:* Support the Uniformity Committee effort, ask for a clear deadline, and solicit possible additional help from states in preparing drafts. After completing a uniformity recommendation on this subject, the Executive Committee should consider how to provide information to the states and the public on the recommended measure. The staff recommends that this be given a top priority for Uniformity Committee work.

2. **Expense Disallowance Statutes.** In lieu of taking the more comprehensive step of combined reporting and perhaps as an intermediate step with consideration of combined reporting as a possible future goal, separate entity states should enact expense disallowance statutes that are broadly worded to address inter-affiliate transactions that involve intangible property and also perhaps inter-affiliate loan transactions. Exceptions for some transactions may be appropriate, but exceptions to these statutes should be objective and narrow in their application as in the expense disallowance statute for intangible property that was enacted by New York State in 2003. **** This recommendation could be forwarded to an appropriate group, such as a specialized uniformity task force, or returned to the Corporate Income**

Tax Sheltering Work Group to provide guidelines to the states on expense disallowance statutes. **

Staff recommendations and commentary: This is a “backup” proposal to combined reporting for those states that cannot enact it. We recommend assigning the to a special work group of state personnel that would prepare a draft and submit it to the Uniformity Committee. Given the focus on the combined reporting project, MTC staff probably cannot take major direct responsibility for the drafting. A Commission recommendation in this area would likely be stated in terms of its being a secondary approach if combined reporting is not adopted by a state.

3. **Overhaul of UDITPA.** It has been almost 50 years since the drafting of UDITPA. Revisions are clearly needed in the area of sales of services and to address intangibles and the financial services sector. An alternate approach is the development of additional special industry rules through the Uniformity Process of the MTC. Rules could be developed for the sales of services; the sales of financial services businesses, such as those with brokerage or insurance activities that do not fit the current financial services rules; and other areas as needed. We recommend the first approach because this is the most direct and thorough, and could be the most effective in influencing state statutes and in taxing corporate income. **** The MTC could propose a cooperative effort with the National Conference of Commissioners on Uniform State Laws to overhaul UDITPA. The MTC could also solicit support from professional and private sector groups for this effort. ****

Staff recommendations and commentary: This recommendation is a major undertaking. This effort should be retained, for now, under the direction of the Executive Committee and likely begins with making a documenting the case for updating UDITPA. This may involve both academic writing as well as practical research on the problems and inequities caused by the current statute. Some early communications with NCCUSL on their interest in this effort would be beneficial. A commitment by states to seeing this long-term process through to completion would be necessary. Additional resources would likely be needed by the Commission to pursue this effort.

4. **Adopt Throwback Rules.** To limit the occurrence of “nowhere income” states should enact throwback or throwout rules for both tangible goods and services. In addition, states should require that throwback affidavits be submitted and share this information with the states identified in affidavits. **** Guidelines for throwback rules should be included in the current MTC effort to develop proposed uniform combined reporting statutes and regulations. ****

Staff recommendations and commentary: There are really two recommendations contained here: 1) development of uniform throwback or throwout rules and 2) an information sharing process based on throwback affidavits. On the first part, the issue would be referred to the Uniformity Committee to be worked on in tandem with the combined reporting project. On the second part, the item might well get referred

to a proposed Information Sharing and Enforcement Task Force—(see comments on referring part of recommendations #'s 5, 6 and 9 below on corporate tax sheltering, recommendation B of the pass-through entity work group and recommendation # 4 of the sales tax work group to the same task force). Two existing subcommittees of the Nexus Committee that are already working on information sharing issues would help support and coordinate with this task force.

5. **Disclosure of Filing Positions.** States should enact provisions that require disclosure of inconsistent filing positions where states have similar requirements. Failure to disclose inconsistent positions should be penalized and presumptions based on failure to disclose inconsistent filing positions should be enacted to encourage appropriate reporting by taxpayers. **** This recommendation could be forwarded to an appropriate group, such as a specialized uniformity task force, or returned to the Corporate Income Tax Sheltering Work Group to provide guidelines to the states on disclosure requirements. ****

Staff recommendations and commentary: We would recommend referring the drafting of these provisions (law or regulation or return requirement) to a special drafting group that would also work on the listed transactions legislation under Section 6. This could be the Corporate Tax Shelter Working Group itself. The drafting group can report directly to the Executive Committee, but the Uniformity Committee should be provided an opportunity to review the draft.

In addition, there is a potential for information sharing following the disclosure of inconsistent information. That portion of this topic should be referred to the proposed Information Sharing and Enforcement Task Force.

6. **Tax Sheltering and Listed Transactions.** States should take advantage of the information sharing on tax shelter activity under the IRS Memorandum of Understanding and the State Memorandum of Agreement. In addition, they should adopt listed transactions legislation that includes, by reference, federal listed transactions, and provides for the definition of state listed transactions. The 2003 California legislation provides a model for the states in this area. **** This recommendation could be forwarded to an appropriate group, such as a specialized uniformity task force, or returned to the Corporate Income Tax Sheltering Work Group to provide guidelines to the states on listed transactions statutes. ****

Staff recommendations and commentary: Again, it is possible to read two separate measures into this recommendation: 1) drafting listed transactions legislation and a coordinated follow-up process for enacting states and 2) assisting the states in following up on the information being shared on tax shelter activity. In terms of the first part, the listed transactions legislation, a special drafting group—perhaps the Corporate Tax Shelter Working Group—should undertake that effort as well as the drafting of the measures for disclosure of inconsistent filing under # 5 above. Consideration needs to be given, though, to whether there are sales and use tax or

other tax issues that might fall within the realm of this legislation. *A high priority should be assigned to drafting this legislation.*

On the second part, the states to determine whether they need any assistance from the Commission or other parties in collaborative efforts on tax shelter issues. Training assistance and joint audits in cases of multistate taxpayers comes to mind. This topic could be assigned to the proposed Information Sharing and Enforcement Task Force referred to under recommendation # 4 above.

7. **Enforce “Doing Business” Statutes.** States should clearly articulate and effectively enforce their nexus standards to ensure more complete reporting of income among the states. In applying nexus standards, states should consider thresholds, taking into consideration costs of administration and compliance.

Staff recommendations and commentary: We would recommend that this remain under the supervision of the Executive Committee at this point.

8. **Proactive Role in Federal Legislation.** The states should take a more proactive role with respect to federal legislation, including legislation that affects state jurisdiction for corporate income taxes and federal issues, such as tax sheltering and corporate inversions, that affect both the federal and state income tax base. This should include advocacy of the MTC factor presence nexus standard and elimination of the restrictions of P.L. 86-272.

Staff recommendations and commentary: We would recommend that this remain under the supervision of the Executive Committee at this point. If the Commission needs to take a more proactive role on the range of items discussed in this recommendation, additional budget resources may be needed.

9. **Enhance Exchange of Information.** Processes should be established to implement, but not be limited to, recommendations 1-8, possibly to include a clearinghouse for sharing information among the states. This information should include current and recent audit activity. Consideration should also be given to including tax shelter activity and other compliance issues.

Staff recommendations and commentary: Again, we recommend a special Information Sharing and Enforcement Task Force. This task force would not only refine information sharing efforts, but would also identify the type of follow-up enforcement steps, be they separate or collaborative, that make the most sense.

Pass-through Entity Compliance Recommendations

The following are listing of recommendations from the Pass-Through Entity Compliance Work Group Report and Proposed Initiatives pages 7 through 9. Please see pages 7 through 9 of the full report for further details on each of these items.

A. Publicize and Encourage States to Adopt the MTC's Uniformity Proposal for Reporting Options for Nonresident Members of Pass-Through Entities.

Withholding of tax on distributed income by the payor of that income remains the primary method to ensure that income of owners from pass-through entities is reported and the tax paid. This is the same primary compliance method that the federal government and the states use for most other forms of income. The Commission has already developed a Uniformity Proposal that provides for withholding on income distributed to nonresident members, where compliance is most problematic. Withholding is imposed, however, only as backup if the entity does not choose to avail itself of the convenience of a composite return reporting and paying tax for nonresident members.

Many states have already adopted various forms of withholding. Most common, and most favored by taxpayers, is withholding only if the taxpayer refuses to file a promise to pay. The Commission felt that while a promise is good, actually getting the tax paid when the income is distributed is vastly better.

**** The remaining effort here, then, is to publicize the MTC proposal and work with states to encourage their adoption of it. ****

Staff recommendations and commentary: We would recommend that this remain under the supervision of the Executive Committee at this point. The focus of activities would be the development of successful methods of encouraging adoption.

B. Work with California, New York and Pennsylvania as Lead States in Developing a Common Database or Data Warehouse on Flow of Income from Pass-Through Entities to Owners.

As indicated by the wide range of the original MTC estimate of revenue loss due to non-compliance by owners of pass-through entities (between \$1 billion and \$12 billion), the largest problem here is simply not knowing what income is earned and where it is going. The complexity of the ownership tree can be enormous. A given pass-through entity can be owned by other pass-through entities, which are, in turn, owned by others, and so on ad infinitum. Into the mix can be added ownership by C Corporations, by trusts, by individuals, both foreign and domestic. Tracing where the income goes can become an impossible task.

Certain lead states have been developing data warehouses and databases that will allow the tracking of the ownership interests of pass-through entities. **** The work group believes that one of the best compliance tools for the states would be to work with these lead states to enhance these databases and obtain the use of the databases, possibly through a fee for service arrangement. The New York Multi-State Tax Shelter Application program that states may utilize by entering into a Memorandum of Agreement may already be on the way to provide the desired capabilities. ****

Staff recommendations and commentary: Again, we recommend that his recommendation be assigned to the proposed Information Sharing and Enforcement Task Force.” Alternatively, there could be a task force that focuses exclusively on pass-through entity issues. We would like to see this task force not only refine information sharing efforts, but also identify the type of individual and coordinated enforcement ideas that make the most sense. Further, any task force needs to coordinate with the California, New York and Pennsylvania efforts.

C. Develop Educational Resources on Pass-Through Entities for the States

The greatest concerns of the states expressed in the survey all centered on the lack of information—information about the character of pass-through entities, about the extent of their activities, about their owners, and about the interrelationships among entities with multiple ownership levels. Ms. Brenda Gilmer (MT) has begun the task of bringing together in one document a collection of references to information about all aspects of pass-through entities. The document provides jump cites to various Internet websites wherein information can be found. The work group applauds this Herculean effort by Ms. Gilmer and recommends that this document continue to be refined for eventual placement on the MTC secure Extranet website to be available to the staffs of member states.

To supplement the educational compendium, the work group recommends the development of training sessions for state auditors on how to recognize pass-through entity issues as well as a more specific training component on sophisticated methods of attacking the latest pass-through entity sheltering techniques

**** To implement this recommendation there will need to be a continuing group to maintain the educational compendium on the website and to develop and run training programs. ****

Staff recommendations and commentary: The Commission has established, but not activated, the Training Advisory Committee comprised of the chairs and vice-chairs of its standing committees. This recommendation could be referred to that group.

D. Create an Ongoing Liaison Group to Work with the Internal Revenue Service to Coordinate Compliance Efforts on Proper Reporting of Pass-Through Entity Income

The conferences with the IRS have confirmed that the IRS is ahead of most of the states on many of its compliance systems for pass through entities. Even the most basic step, the matching of income reported by entities on Schedule K-1s to the income reported by the owners on their returns would be an enormous help to the states. MTC Executive Director Dan Bucks recently met with IRS Commissioner Everson and had a very

productive discussion on how the states and the IRS could work together. **** The work group strongly recommends that the Commission and the states create a liaison group to continue to forge alliances with the IRS for mutual compliance assistance with specific reference to pass-through entities. ****

Staff recommendations and commentary: We recommend that the Executive Committee oversee the recruitment of members for this liaison group. This group should be open to all states and coordinated with the FTA.

Sales and Use Tax Recommendations

The Executive Committee has previously acted on the first four of the following recommendations, and the fifth has been referred to the Resolutions Committee. Thus, they are listed here only in summary form. For further details, please see pages 8-11 of the Sales and Use Tax Compliance Work Group Report.

1. Develop a Template for Informational Mass-Mailings to CPA's and Tax Practitioners. **** The initiative could be assigned back to the Sales & Use Tax Compliance Work Group for implementation. ****

Staff recommendations and commentary: We support this referral back to the Sales and Use Tax Compliance Work Group and note that Texas and Missouri have played a leadership role on this issue.

2. Promote Awareness of the Existing MTC Voluntary Disclosure Program. **** The Work Group recommended this initiative be forwarded to an appropriate MTC standing committee for implementation. ****

Staff recommendations and commentary: This item could be referred either to the Nexus Committee assisted by a special work group that reaches out to parts of agencies other than those involved in nexus discovery or enforcement. Assistance from experts in public information and education efforts would be helpful in this effort.

3. Develop an MTC Proposed Uniform Affiliate Nexus Statute or Regulation. **** The Work Group recommended this initiative be forwarded to the MTC Uniformity Committee for further development and implementation. ****

Staff recommendations and commentary: The Uniformity Committee, through its sales tax subcommittee, should have responsibility for this proposal. Further, it should be assigned a high priority.

4. Enhance Exchange of Information to Improve Identification of Non-Filing Companies that have Sales and Use Tax Nexus. **** The Work Group**

recommended this initiative be forwarded to an appropriate MTC standing committee for further development and implementation. **

Staff recommendations and commentary: Again, we recommend this topic be referred to an Information Sharing and Enforcement Task Force. There would be a need for a subgroup within the task force that focuses on the sales and use tax area.

5. Review and Reissue Multistate Tax Commission Policy Statement 2002-01, titled Improving State Sales Taxes to Achieve Fairness and Simplicity.

Staff recommendations and commentary: This item has been referred to the Resolutions Committee.

Attached Table Summarizing Recommendations

The attached table summarizes staff recommendations on the assignment of initial work on each measure. Because of its summary form, it does not note additional resources that may be required, public information efforts that would be desirable, or all of the coordination and communication that will be needed with other committees, organizations and parties for a measure to be successful. It is simply intended as a short guide to possible initial implementation steps.

Summary of Staff Implementation Recommendations CS=Corporate Shelter Recommendation PE=Pass-Through Entity Recommendation ST=Sales and Use Tax Recommendation			
<i>Measure</i>	<i>Standing Committee</i>	<i>Special Task Force</i>	<i>Executive Comm.</i>
CS 1: Combined Reporting	Uniformity Comm., <i>High Priority</i>		
CS 2: Expense Disallowance Statute	Uniformity Comm., through a special drafting group of interested state personnel.		
CS 3: UDITPA Overhaul			Executive Committee
CS 4: Throwback Rules	Drafting to Uniformity Comm., in conjunction with combined reporting draft.	Information sharing issues to proposed Information Sharing and Enforcement Task Force. (Reach out to all states & FTA.)	
CS 5: Disclosure of Filing Positions		a) Drafting to the Corporate Tax Shelter Work Group or another group. b) Information sharing to proposed Information Sharing and Enforcement Task Force.	
CS 6: Tax Sheltering and Listed Transactions		a) Drafting to the Corporate Tax Shelter Work Group or another group. <i>High Priority.</i> b) Tax shelter assistance and follow up to proposed Information Sharing and Enforcement Task Force.	
CS 7: Enforce Doing Business Statutes			Executive Committee

CS 8: Proactive Role on Federal Legislation			Executive Committee
CS 9: Enhance Exchange of Information		Proposed Information Sharing and Enforcement Task Force	
PE A: Publicize MTC Uniformity Proposal on Income Reporting			Executive Committee
PE B: Database on Pass-Through Entity Ownership		Proposed Information Sharing and Enforcement Task Force	
PE C: Educational Resources	Training Advisory Committee (Chairs and Vice-Chairs of Committees)		
PE D: Liaison Group with IRS			Executive Committee. Reach out to all states and FTA.
ST 1: Use Tax Template for Tax Practitioners		Sales and Use Tax Compliance Work Group	
ST 2: Voluntary Disclosure Program Awareness	Nexus Committee with the support of a special work group reaching beyond nexus discovery and enforcement staff.		
ST 3: Uniform Affiliate Nexus Statute	Uniformity Committee, <i>High Priority.</i>		
ST 4: Exchange of Information—Non-filers with Nexus		Proposed Information Sharing and Enforcement Task Force	
ST 5: Review and Reissue Policy Statement 02-01	Resolutions Committee (underway)		